Global Economic Outlook
Webinar with Canterbury Consulting and PIMCO's Joachim Fels

On June 30, 2015, Joachim Fels, Managing Director & Global Economic Advisor at PIMCO, presented on themes and outlook from PIMCO's secular forum and shared investment views for the "New Neutral" environment

PIMCO'S SECULAR FORUM: THEMES AND OUTLOOK

— The purpose of PIMCO's semi-annual Secular Forum is to provide the concept, the construct, and the compass to navigate global markets over the next three to five years

— Four key themes discussed during this May's forum: Inflation & Monetary Policy, Banking System, Energy, and Geopolitics

— PIMCO reaffirmed its New Neutral thesis from 2014 as a natural evolution of the 2009 New Normal in describing the investment landscape over the next three to five years. The new neutral (equilibrium) interest rate will be much lower than in previous cycles as growth converges to slowing trend trajectories

— Three reasons for the New Neutral:

- Lower output growth due to lower population & productivity growth
- Low inflation
- Global savings glut and investment drought

THE NEW NEUTRAL REVISITED: A CAUTIOUSLY OPTIMISTIC VIEW OF THE WORLD

Five Reasons for Optimism:

— The "left tail of deflation" has been clipped by central banks. Deflation "an unknown devil" is perceived as a greater threat than inflation "a known devil"

— The global economy is learning to "live with" leverage. Interest rates are low and public debt is replacing private debt

— Recapitalization of the banking industry contributes to a safer global system. Banks continue to operate with multi-decade high levels of capital

— Moving from energy scarcity to "energy abundance" thanks to the shale revolution is a net positive for the global economy. Non-OPEC supply has been increasing in importance

— Global imbalances are being reduced, meaning that the global economy is a safer place than it used to be. The middle-income transition in China will be key to the secular rebalancing process

Five Reasons for Caution:

— High leverage and poor demographics mean central banks need to tread cautiously. It will be difficult to pursue expansionary fiscal policy in the event of a future downturn

— Germany is not yet helping global rebalancing. The German current account surplus as a percentage of GDP continues to grow. Germany is becoming the new China. This makes it more difficult for deficit countries to reduce their deficits

— A more stable banking system, but a market vulnerable to "flash crashes." Dealers are less able and willing to hold inventory. Banks are no longer acting as a cushion to absorb spikes in bond supply. This has led to reduced liquidity in the bond market

— Energy revolution: Not all participants are created equal…and will the West spend the gains? Biggest winners: EU, U.S., and China; biggest losers: OPEC, Russia, and Brazil. Meanwhile real consumer spending has no picked up in the U.S.

— Geopolitical risks remain a headwind. Better economic policies are emerging in a number of regions, but geopolitical risks will be widespread, and a source of volatility/tail risks

Key Conclusions:

— **Growth:** Cautiously optimistic as the world has learned to live with leverage

— **Inflation:** Deflation has been averted, but there is limited room for maneuver in the event of a downturn

— **Banking System:** More stable, but more prone to liquidity shocks

— **Energy:** Good overall, but the transition from scarcity to abundance will create winners and losers, as well as EM differentiation

— **Geopolitics:** Risks remain and shocks can emanate from multiple regions

INVESTMENT IMPLICATIONS AND POSITIONING AT PIMCO

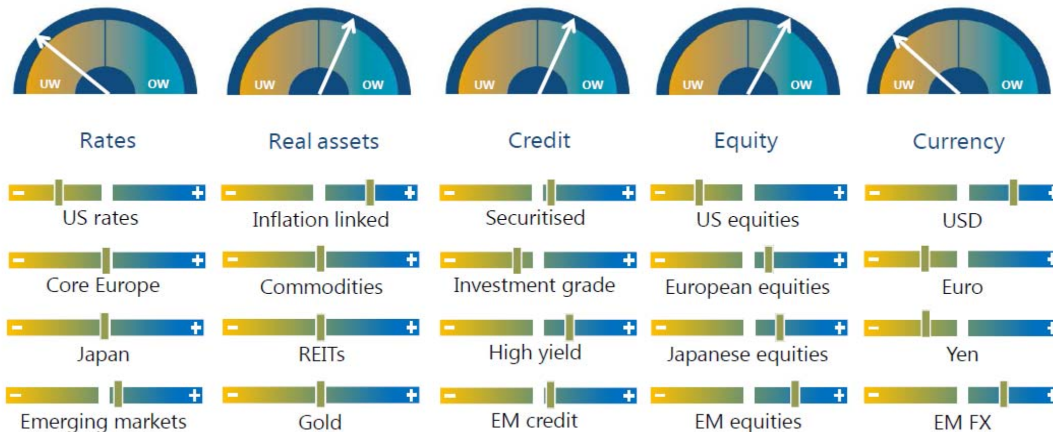
— Since 1982, both official interest rates and the U.S. 10-Year Treasury yield have been steadily declining with lower terminal rates each cycle. Lower rates going forward are supportive for asset valuations. The current cycle could easily last another five to six years. However, investors must get used to lower returns across asset classes.

— Five positioning views:

- Inflation – markets are pricing in an insufficient inflation premium in the U.S. Favor U.S. TIPs over Europe as attractively priced inflation hedges
- Global rates – focus on central bank divergence on path to normalization. The Fed will likely raise rates earlier and more often than the market is pricing in. Inflation should rise back to target within 6 months. Be cautious on duration given the Fed tightening cycle and the low level of German yields in Europe
- Global credit – there are pockets of value across the credit spectrum. Credit market valuations are broadly fair. Attractive opportunities lie in high yield and emerging markets. Focus on alpha-generating security selection
- Global equity – the extended business cycle is supportive for equity valuations; country selection is important. PIMCO is constructive on equities, but favors Europe, Japan, and EM over the U.S. within the space
- Currency – the USD is set for secular strengthening. Despite a recent healthy correction, the USD should continue to strengthen as the Fed begins to tighten

Putting it all together: Overall views

US strength driver of performance over secular horizon



As of 31 May 2015.
SOURCE: PIMCO.
Refer to Appendix for additional outlook and risk information.

Q&A W/ JOACHIM FELS

What are your thoughts on Greece?

We think there's a 2/3rds chance that it stays in the Eurozone. It is dawning on the Greek population what an exit would mean—a new currency, which would depreciate, leading to much more expensive imports (energy, pharmaceuticals, food). Europe has an interest in keeping Greece because other markets could come under pressure if Greece leaves due to a decrease in investor confidence. The key date is the 20th of July, when Greek's ECB bonds will come due. If they default, the ECB will withdraw their emergency liquidity assistance and Greece will be forced out of the Eurozone and into a new currency. We think they will find a compromise before then

Equity and bond markets seem overvalued. How does your New Neutral thesis affect perceived valuation?

If you accept the New Neutral thesis, you believe that interest rates will rise but settle lower than historical norms, which supports valuation. If you have lower interest rates for longer, higher valuations are justified since future cash flows are more valuable

What will the effects of central bank deleveraging be?

Balance sheets are bloated. They may not shrink even as banks raise interest rates. The Fed is both data dependent and financial condition dependent. If what they do creates volatility in markets, then they will proceed more cautiously. Only when things are back to normal (perhaps in the next cycle) we may see balance sheets shrinking gradually. This decline should occur naturally as bonds mature

What opportunities does the volatility due to the Greek crisis create? Should we expect more volatility in the future?

As we're entering the Fed's first tightening cycle in over 10 years, it's natural to expect more volatility. Even if Greece stays in the Eurozone, the problem does not go away, so it will continue to contribute to volatility. China is another source of risk. Volatility does create opportunities, such as the widening in spreads in Europe.

How are recent regulatory changes in the U.S. affecting volatility here?
Regulators have been forcing banks to raise capital and shrink balance sheets. The higher volatility is partly a consequence of regulatory action. Higher volatility means that the price for liquidity is going up, so we have to take a longer time horizon

Where will the 10-Year Treasury yield sit at the end of the year?
Bond yields will be higher. It's doubtful that we'll see 3%, but we can see them at 2.75% or maybe more if the data remains strong

What do you think the Fed's rate-raising schedule will be?
We think they will start in September and hike again in December as data stays strong. The economy is relatively robust, and equity markets will be able to withstand the first rate hike

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Joachim Fels
PIMCO, Managing Director and Global Economic Advisor
Mr. Fels is a managing director and global economic advisor based in the Newport Beach office. Prior to joining PIMCO in 2015, he was a managing director and chief economist at Morgan Stanley in London. During 19 years with Morgan Stanley, he also served as chief international economist, chief global fixed income economist and co-head of European economics. Previously he was an executive director and international economist at Goldman Sachs, and prior to this he was a research associate at Kiel Institute for the World Economy. Mr. Fels was also a founding member of the ECB shadow council and a member of the economic and monetary committee of the Association of German Banks. He has 28 years of macro research experience and holds a diploma in international studies from the Johns Hopkins University School of Advanced International Studies in Bologna, Italy; a master's degree in economics from Universität des Saarlandes in Saarbrücken, Germany; and an undergraduate degree from Christian-Albrechts-Universität in Kiel, Germany

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Mr. Lui is a member of Canterbury's Research Group and is responsible for sourcing, evaluating, and monitoring traditional, long-only equity managers. Prior to joining Canterbury, Mr. Lui was a trader and research analyst at Knightsbridge Asset Management. Mr. Lui received a degree in Economics from U.C. Berkeley and is a CFA charterholder.

About Canterbury

Canterbury Consulting is a leading investment advisory firm for foundations, endowments, and families. We currently oversee more than $13 billion for our clients. Canterbury designs and manages customized investment programs whereby we are the investment office for our clients. In that role, we provide objective and aligned investment advice, asset allocation, manager selection, risk management, implementation, and performance measurement. Our goal is to deliver a program that exceeds the needs and expectations of our clients in terms of performance and service.